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PREEMPTION IN THE SECURITIES INDUSTRY: A DIMINISHED STANDARD?

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How should the power between the governments of the states and the United States be divided? The federalist structure created by our founding fathers seemed to achieve an effective balance,¹ and the states' ratification of the Constitution temporarily remedied this controversy. Nearly 200 years later, a comfortable balance between state and federal government has yet to be discerned. Today, the states retain much of their sovereign power, but Congress, pursuant to its power under the Supremacy

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¹ See *Gregory v. Ashcroft*, 501 U.S. 452, 458–60 (1991) (holding that the Missouri Constitution's mandatory retirement provision for appointed state judges did not violate the Federal Age Discrimination in Employment Act). The Supreme Court described the federalist structure contemplated by the Constitution, noting that:

This federalist structure of joint sovereigns preserves to the people numerous advantages. . . .

Perhaps the principal benefit of the federalist system is a check on abuses of government power. "The 'constitutionally mandated balance of power' between the States and the Federal Government was adopted by the Framers to ensure the protection of 'our fundamental liberties.'" Just as the separation and independence of the coordinate branches of the Federal Government serve to prevent the accumulation of excessive power in any one branch, a healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front. . . .

If this "double security" is to be effective, there must be a proper balance between the States and the Federal Government. These twin powers will act as mutual restraints only if both are credible. In the tension between federal and state power lies the promise of liberty.

The Federal Government holds a decided advantage in this delicate balance: the Supremacy Clause. As long as it is acting within the powers granted it under the Constitution, Congress may impose its will on the States. Congress may legislate in areas traditionally regulated by the States. This is an extraordinary power in a federalist system. It is a power that we must assume Congress does not exercise lightly.

Id. (citations omitted); see also Neil M. Richards, *Clio and the Court: A Reassessment of the Supreme Court's Uses of History*, 13 J.L. & POL. 809, 879 (1997) ("To many eighteenth century American intellectuals, the constitutional division of sovereign power into three branches, each corresponding to one of the three forms of government power, was a beautiful intellectual construct . . .").

Clause,² may preempt a field of law, explicitly or implicitly. Historically, the Supreme Court has expressed a presumption against preemption³ absent a "clear and manifest purpose of Congress."⁴

In the securities industry, the battle for regulation supremacy is manifested by conflicts between the Securities and Exchange Commission (SEC) and state blue-sky laws. The SEC is a regulatory agency created pursuant to the Securities Exchange Act (the "Exchange Act") as a supplement to state blue-sky laws.⁵ Its primary purpose was, and is, to protect the investing public by ensuring that investors are provided with full disclosure of all material information prior to engaging in securities transactions.⁶ SEC rules were traditionally subjected to the same pre-

² See U.S. CONST. art. VI, § 2, cl. 2. The clause reads:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Id.; see also S. Candice Hoke, *Preemption Pathologies and Civic Republican Values*, 71 B.U.L. REV. 685, 722 (1991) (discussing the circumstances under which preemption is ordinarily found). Hoke notes that:

The power to rule that state legislation is preempted by a federal legislative scheme ultimately flows from the supremacy clause, which literally directs that any state law which is contrary to valid federal law shall be displaced in favor of the federal rule. The supremacy clause's impact, however, is not limited to the conflict between a valid federal *statutory* scheme and a state law; the preeminence of federal *constitutional* provisions, such as the equal protection and due process clauses, over conflicting state laws also is grounded in the supremacy clause.

Id. (footnotes omitted).

³ See, e.g., *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963) (stating that the doctrine of preemption may not be invoked in the field of commerce unless either "the nature of the regulated subject matter permits no other conclusion, or . . . Congress has unmistakably so ordained"); *Schwartz v. Texas*, 344 U.S. 199, 202-03 (1952). The Court stated that

[i]f Congress is authorized to act in a field, it should manifest its intention clearly. It will not be presumed that a federal statute was intended to supersede the exercise of the power of the state unless there is a clear manifestation of intention to do so. The exercise of federal supremacy is not lightly to be presumed.

⁴ *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (noting the importance of congressional intent in a preemption analysis); see also *Douglas v. Seacoast Prods.*, 431 U.S. 265, 272 (1977) (quoting *Rice*); *R. Mayer of Atlanta, Inc. v. City of Atlanta*, 158 F.3d 538, 542 (11th Cir. 1998), *cert. denied*, 119 S. Ct. 1334 (1999).

⁵ See *infra* note 36 and accompanying text.

⁶ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The *Ernst* court noted that

sumption against preemption as any other federal law.⁷ Recent decisions, however, threaten to destroy state sovereignty in the securities industry without the required showing of congressional intent to do so. *Guice v. Charles Schwab & Co.*,⁸ exemplifies a recent trend of faulty judicial analyses applying the Supreme Court standard for preemption to the securities industry.

In *Guice*, the New York Court of Appeals held plaintiffs' state law claims, alleging violations of common law fiduciary duties, to be implicitly preempted by federal law.⁹ Specifically, the Court addressed Rule 10b-10,¹⁰ promulgated by the SEC pursuant to the 1975 amendments of the Securities Exchange Act of 1934.¹¹ *Guice* involved a practice "known in the securities industry as 'order flow payments.'"¹² The practice of payments for order flow ("POF") consists of retail securities broker-dealers sending their customers' orders to market makers in return for monetary or sometimes non-monetary remuneration.¹³ The plaintiffs in *Guice* included former retail customers of one of the defendants, Charles Schwab & Co. ("Schwab"),¹⁴ a " 'discount' stock brokerage house [that], . . . charge[s] reduced commissions for effecting securities transactions . . . on behalf of customers who have already decided upon what securities to buy or sell."¹⁵

[t]he Securities Act of 1933 (1933 Act) was designed to provide investors with full disclosure of material information . . . to protect investors against fraud. . . . The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.

Id. (citations omitted).

⁷ See *infra* note 35.

⁸ 674 N.E.2d 282 (N.Y. Ct. App. 1996), *cert. denied*, 520 U.S. 1118 (1997).

⁹ See *id.* at 284.

¹⁰ See C.F.R. § 240.10B-10 (1999), SEC Commodity and Securities Exchanges Rule, Confirmation of transactions. This provision requires a broker to disclose to the customer, in a confirmation slip, whether the broker received any remuneration in connection with the transaction. Additionally, the disclosure informed the customer that more information could be had upon request.

¹¹ See generally Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

¹² *Guice*, 674 N.E.2d at 284.

¹³ See *id.*

¹⁴ See *id.* In *Guice*, the New York Court of Appeals consolidated two cases into one appeal, however, for the purposes of this article, the author focuses on the lead plaintiff, *Guice*, and the defendant, Charles Schwab & Co.

¹⁵ *Guice*, 674 N.E.2d at 284.

In *Guice*, defendant, Schwab, indisputably complied with the disclosure requirements of Rule 10b-10.¹⁶ Nevertheless, plaintiffs' alleged that defendant's receipt of remuneration for order flow was the equivalent of "kickbacks"¹⁷ and their failure to disclose such amounts constituted a breach of fiduciary duty under common law agency principles.¹⁸ Additional allegations included breach of contract,¹⁹ violations of New York criminal law prohibiting commercial bribery²⁰ and violations of The Martin Act, a

¹⁶ See *id.* at 287 ("It is uncontested that Schwab . . . complied with the applicable disclosure requirements of . . . rule 10b-10 on the confirmation statements . . . sent to . . . the . . . plaintiff . . .").

¹⁷ *Id.* at 288.

¹⁸ See *id.* In *Guice*, the Court did not specify exactly which common law agency principles were implicated in this matter. The Court did note, however, that the Restatement (Second) of Agency provides that when there is a conflict of interest between the agent and the principal, the agent must provide "advance disclosure . . . of 'all facts which the agent knows or should know would reasonably affect the principal's judgement' whether to consent to the agent's dual role." *Id.* at 289. (citing RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)). Additional provisions of the Restatement further illustrate the fiduciary duty that existed in *Guice* under common law agency principles. Section 387 establishes the general rule that "[u]nless otherwise agreed an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." *Id.* § 387 (1958). Section 388 states that "[u]nless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal." *Id.* § 388. Comment (f) to section 427, dealing with the time when a cause of action for breach of fiduciary duty arises, concludes, "[a] concealment by the agent of the fact of collection or its amount . . . sufficiently indicates that the demand of the principal will not be met, and suit can be brought by the principal without more." *Id.* § 427 cmt. f.

¹⁹ See *Guice*, 674 N.E.2d at 284. Plaintiffs claimed that Schwab breached its contractual duty by not obtaining the best market price for the customer, most often referred to as the duty of "best execution." The theory is that the market maker (the party paying for the order flow), who is dealing for herself, looks for the best spread (between the bid and ask price). This practice is, arguably, contrary to the interests of the customer. See, e.g., *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998), *cert. denied*, 119 S. Ct. 44 (1998) (noting that "[t]he duty of best execution . . . predates the federal securities laws . . . [and] requires the broker to use reasonable efforts to maximize the economic benefit to the client in each transaction").

²⁰ See *Guice*, 647 N.E.2d at 284; see also N.Y. PENAL LAW § 180.05 (McKinney 1999). Section 180.05 provides:

An employee, agent or fiduciary is guilty of commercial bribe receiving in the second degree when, without the consent of his employer or principal, he solicits, accepts or agrees to accept any benefit from another person upon an agreement or understanding that such benefit will influence his conduct in relation to his employer's or principal's affairs.

Id.

New York statute regulating the conduct of securities brokers.²¹ Schwab successfully moved to dismiss in the Supreme Court.²² The motion to dismiss was based primarily on two United States Constitutional grounds. First, Schwab argued that plaintiffs' common law cause of action violated the Commerce Clause.²³ Second, Schwab argued that under the Supremacy Clause,²⁴ plaintiffs' other claims were preempted by Rule 10b-10.²⁵

On appeal, the Appellate Division reinstated all of plaintiffs' claims concluding that a common law tort action was neither inconsistent nor in conflict with the federal regulatory scheme.²⁶ Thus, the Appellate Division ruled that preemption was absent because "Congress had passed no statute dealing directly with order flow payments and . . . the SEC had not promulgated any final regulations regarding the receipt of order flow payments."²⁷ The Appellate Division remanded the case to the

²¹ See *Guice*, 647 N.E.2d at 284; see also N.Y. GEN. BUS. LAW § 352-c(6) (McKinney 1996). This section provides:

Any person, partnership, corporation, company, trust or association, or any agent or employee thereof who intentionally engages in fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale, or who makes any material false representation or statement with intent to deceive or defraud, while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of any securities or commodities, as defined in this article, and thereby wrongfully obtains property of a value in excess of two hundred fifty dollars, shall be guilty of a class E felony.

Id.

²² See *Guice*, 674 N.E.2d at 285 (noting that the New York Supreme Court found "plaintiffs' causes of action were preempted by the Securities Exchange Act of 1934 . . . and the SEC regulations promulgated thereunder").

²³ See *Guice*, 674 N.E.2d at 284. The Commerce Clause is found in the United States Constitution. See U.S. CONST. art. I, § 8, cl. 3 (granting Congress the power to "regulate commerce with foreign nations, and among the several States, and with the Indian tribes"); see also U.S. CONST. art. I, § 8, cl. 18 (authorizing Congress "[t]o make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof").

²⁴ See U.S. CONST. art. VI, cl. 2.

²⁵ See *Guice*, 674 N.E.2d at 284-85.

²⁶ See *id.* at 285.

²⁷ *Guice v. Charles Schwab & Co.*, 630 N.Y.S.2d 317, 318 (App. Div. 1995), *rev'd*, 674 N.E.2d 282 (N.Y. Ct. App. 1996) (citing *Dahl v. Charles Schwab & Co.*, 524 N.W.2d 742, 744-45 (Minn. Ct. App. 1995). The Appellate Division in *Guice* agreed with the rationale of the *Dahl* court in holding that New York law does not conflict with federal law, i.e., that no SEC rule specifically displaces state law with respect to payment for order flow. The court noted that the Supreme Court standard forbade

Supreme Court to decide defendant's remaining motions for dismissal,²⁸ but the Appellate Division also granted Schwab leave to appeal, to the New York Court of Appeals, for a determination of whether the Appellate Division's modification order was proper.²⁹ The New York Court of Appeals reversed the order of the Appellate Division, and held that plaintiffs' state law claims were preempted.³⁰

The preemption analysis of the New York Court of Appeals, in concluding that state law causes of action were preempted by the federal statutory scheme, is flawed. An examination of the purpose and background of Rule 10b-10, and a reading of the legislative history of the 1975 amendments to the Global Exchange Act, reveals that state law causes of action challenging POF are neither expressly, nor implicitly preempted under the standard articulated by the United States Supreme Court. On the contrary, Congress explicitly preserved state law causes of action.³¹

This article is submitted solely for the proposition that *Guice* was decided incorrectly under pre-existing federal rules and created bad preemption analysis precedent. The author recognizes that recent SEC amendments may very well preempt state laws regarding POF, therefore *Guice* will be used solely as a model for comparing the proper preemption analysis to be applied in the securities field as in any other field. Part I of this comment presents the standard for preemption. Part II summarizes the *Guice* ruling as background for analyzing how this decision, and others like it, threaten state sovereignty in the securities industry. Part III offers a correct application of the preemption test to *Guice* and analyzes the mistaken rationale of the court. Part IV considers whether the standard for preemption has indeed been diminished, how future cases might be affected, and what role the courts should have in securities litigation.

a finding of preemption absent a clear manifestation of an intention to preempt by Congress or the SEC.

²⁸ See *Guice*, 630 N.Y.S.2d at 319.

²⁹ See *Guice v. Charles Schwab & Co.*, 636 N.Y.S.2d 621 (granting defendant leave to appeal to the Court of Appeals).

³⁰ See *Guice v. Charles Schwab & Co.*, 674 N.E.2d at 285, 288-92 (dismissing the complaint because the Appellate Division's modification was not proper).

³¹ See 15 U.S.C. § 78bb (1994). This provision is known as the Savings Clause, which explicitly preserves state law causes of action in the securities industry.

I. PREEMPTION: THE STANDARD AS ARTICULATED BY THE SUPREME COURT

In *Guice*, Schwab, the defendant, argued that plaintiffs' state law causes of action were preempted by Rule 10b-10, promulgated by the SEC pursuant to the 1975 amendments of the Exchange Act of 1934.³² Defendant argued that enforcement of plaintiffs' claims violated both the Commerce Clause³³ and the Supremacy Clause of the Constitution.³⁴ This argument could be successful only if Congress, or the SEC, preempted state law. In performing a preemption analysis, the courts "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."³⁵ This is logical in light of the fact that the SEC was created subsequent to the states' request of Congress to form a regulatory body as a *supplement* to state law.³⁶

³² See 15 U.S.C. §§ 78a-78mm (1994).

³³ See U.S. CONST. art. I, § 8, cl. 3.

³⁴ See U.S. CONST. art. VI, cl. 2.

³⁵ *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (referring to the Securities Exchange Act of 1934); see also Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525, 533 (1995) (noting three recent Supreme Court decisions, *Freightliner*, *Cippolone*, and *O'Melveny*, which evince an attitude that makes it very unlikely that the Court will find implied preemption absent clear congressional intent). Specifically, these commentators noted that

[t]hese three cases indicate that unless preemption is clearly expressed in the statutory scheme, state law will not be preempted. If the securities industry wants to be subject exclusively or primarily to uniform federal law . . . there is a clear need to lobby Congress . . . and the SEC . . . to clearly enunciate the preemptive scope of the federal securities laws and SEC rules and regulations.

Id. at 538. "Historically, the Supreme Court [in its role as interpreter] has applied a presumption against preemption." *Id.* at 533.

³⁶ See Manning Gilbert Warren III, *Legitimacy in the Securities Industry: The Role of Merit Regulation*, 53 BROOK. L. REV. 129, 132 (1987). Warren stated that [t]he states' role in providing investor protection was not a "me too" response to federal regulation. When Congress adopted the 1933 Act, every state but Nevada had enacted blue-sky laws during the preceding twenty years. Because of an unprecedented deluge of worthless securities offerings in the 1920s and jurisdictional limitations on enforcement, state securities administrators asked Congress for a "supplemental" federal law to fill the gap in their preexisting regulatory schemes.

Id. (footnotes omitted).

Preemption can be found in a variety of situations. Congress may expressly preempt state law, which does not automatically foreclose a finding against preemption,³⁷ or, as was found in *Guice*,³⁸ preemption may be implied. Implied preemption can occur in two ways: one, when conflicts between state and federal law render compliance with both impossible,³⁹ or, two, when state law frustrates the purpose of Congress.⁴⁰ In *Guice*, the court ruled that state law frustrated the purpose of Congress.⁴¹

The case law involving preemption by the Exchange Act is limited.⁴² Available cases, however, indicate that there is no express field of preemption in the securities industry.⁴³ In fact, Section 28(a) of the Exchange Act contains a savings clause that evinces Congress's intent to preserve state law claims.⁴⁴ Thus,

³⁷ See *CSX Transp., Inc. v. Easterwood*, 507 U.S. 658, 664 (1993) (noting that even when a congressional statute contains an express preemption clause, the statutory construction must begin with the plain language of the statute to determine Congress's intent).

³⁸ See *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 291-92 (N.Y. Ct. App. 1996).

³⁹ See e.g., *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963). Conflict preemption will be implied where "compliance with both federal and state regulations is a physical impossibility." *Id.*

⁴⁰ See e.g., *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). Conflict preemption may also be implied where "[state] law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Id.*

⁴¹ See *Guice*, 674 N.E.2d at 291. The congressional purpose the court referred to was the concept of a National Market System.

⁴² See *Facciolo & Stone*, *supra* note 35, at 538-39 (discussing three "discrete areas where a preemption . . . analysis has been applied [in the securities industry:] tender offers; control person liability; and the availability of damages other than 'actual damages for pendent state claims'"); see also *International Paper Co. v. Ouellette*, 479 U.S. 481, 494 (1987) (noting that a state law is an obstacle "if it interferes with the methods by which the federal statute [is] designed to reach [its] goal").

⁴³ See *Facciolo & Stone*, *supra* note 35, at 538 (noting that the numerous federal court cases pleading both federal fraud claims and state statutory and common law claims are evidence that securities claims generally do not preempt state common law or statutory fraud claims).

⁴⁴ See 15 U.S.C. § 78bb(a) (1994). Section 78bb(a) provides, in pertinent part: The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not

the issue becomes whether, after applying the Supreme Court standard for preemption and considering the savings clause in Section 28(a), the *Guice* court correctly concluded that either the SEC or Congress intended to preempt state law with regard to POF.⁴⁵

II. RATIONALE OF THE COURT

In reversing the Appellate Division, the New York Court of Appeals concluded that plaintiffs' state law claims were "preempted by the 1975 amendments to the Exchange Act and implementing SEC regulations."⁴⁶ The *Guice* court found preemption, not in any particular congressional action,⁴⁷ but in an all-embracing concept referred to as the National Market System (NMS).⁴⁸ The *Guice* court, citing the Minnesota Supreme Court case of *Dahl v. Charles Schwab & Co.*,⁴⁹ reasoned that more

conflict with the provisions of this chapter or the rules and regulations thereunder.

Id.; see also Warren, *supra* note 36, at 132-33 (noting that the purpose of the savings clause was so investors would look to the states for protection). The author also notes that of all the amendments to the Securities Exchange Act of 1934 over the years, the savings clause has never been altered or amended. That is, until 1998. See 144 CONG. REC. H10266 (daily ed. Oct. 9, 1998). This conference report was issued in response to S.1260, the Securities Litigation Uniform Standards Act of 1998. The purpose of S.1260 is to reverse the trend of securities class actions being filed in state courts in order to avoid the stringent requirements in the federal courts. The Act proposes that Federal court be the exclusive venue for most securities class action lawsuits. The Act is aimed at protecting employees, shareholders, and companies from meritless suits, where the company is forced to settle in order to avoid expensive litigation. The savings clause will be amended by substituting "[e]xcept as provided in subsection (f), the rights and remedies" for "[t]he rights and remedies." *Id.*

⁴⁵ As will be discussed in Part IV, the major problem with the *Guice* decision is that the rationale put forth in finding preemption applies not only to the primary issue in that case (POF), but to all areas of securities regulation.

⁴⁶ *Guice*, 674 N.E.2d at 285.

⁴⁷ Cf. Facciolo & Stone, *supra* note 35, at 569-584 (analyzing application of the Supreme Court's preemption test in two cases involving conflict between the Williams Act and state law). The Williams Act focused on the issue of tender offers. The 1975 amendments to the Securities Exchange Act of 1934 addressed particular issues but did not intend to effect a specific area of law, like tender offers. The general purpose of the 1975 amendments was to grant the SEC authority to do what it deemed necessary in order to promote competition in the securities industry by providing a level playing field that would benefit the consumer. See S. REP. NO. 94-75, at 2-3 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 180.

⁴⁸ See *Guice*, 674 N.E. 2d at 285-86, 289.

⁴⁹ 545 N.W.2d 918 (Minn. 1996). The *Dahl* decision is, in effect, the lead case for all POF claims. The *Dahl* court held that Minnesota law, requiring an agent to ob-

stringent state requirements, concerning disclosure of POF, conflicted with Congress' plan for the NMS.⁵⁰ The court held that allowing a state law cause of action to persist would inevitably "undermine [the finely crafted and balanced Federal] regulatory structure."⁵¹ It is not clear from the *Guice* opinion why allowing a state law cause of action to persist would frustrate Congress's plan for the NMS. The court did not seem convinced with its own reasoning. It cites to *Dahl*, which was based on impossibility, a preemption prong never considered by the *Guice* court.⁵² The Court of Appeals avoided any meaningful substantive analysis, relying exclusively on the NMS argument for its conclusion.⁵³

Congress, in 1975, granted the SEC expansive authority to carry out the NMS.⁵⁴ Congress believed that it was in the public interest for the SEC to take a larger role in policing the securities industry.⁵⁵ The SEC, under the 1975 amendments, was "directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly

tain the principal's consent before retaining any remuneration, conflicted with federal rule 10b-10, which requires only disclosure after the fact. *See id.* at 925. The court agreed with Schwab's argument that complying with state law would be impossible because POF is determined in the aggregate to overcome the difficulty in keeping track of the pennies per share that Schwab receives per transaction. *See id.* The court deemed this to be a compelling argument. *See id.* Ironically, the *Guice* court never spoke of impossibility, although it did acknowledge its agreement with the *Dahl* decision. Instead, the New York Court of Appeals focused on frustration of purpose. *See Guice*, 674 N.E.2d at 290.

⁵⁰ *See Guice*, 674 N.E.2d at 289; *see also* S. REP. NO. 94-75, at 1-3 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 180-81. Congress's purpose for the 1975 amendments, and its goal for the NMS, was simply to facilitate a more efficient market place. *See id.* The main concern of the 1975 amendments was for the SEC to police the self-regulatory organizations in the market place and to ensure fair competition. *See id.* at 181. Nowhere in the legislative history will a reader find the phrase POF, nor is there any suggestion that the SEC should rethink and restructure the agency/principal relationship, and in particular, disclosure to customers. Congress expressed approval of SEC actions leading up to the amendments, including the development of uniform capital requirements, prohibition of commission fixing, and assistance in the establishment of a national clearing system. *See id.* at 180-81. For a similar description of the reasons for the creation of the NMS, see H.R. CONF. REP. NO. 94-229 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 323.

⁵¹ *Guice*, 674 N.E.2d at 292 (alteration in original) (quoting *International Paper Co. v. Ouellette*, 479 U.S. 481, 497 (1987)).

⁵² *See id.*

⁵³ *See id.*

⁵⁴ *See id.* at 286 (quoting S. REP. NO. 94-75, reprinted in 1975 U.S.C.C.A.N. 179, 180) ("[T]he SEC is granted broad and flexible authority to shape a new market system adequate to the needs of investors in this country and around the world.").

⁵⁵ *See Guice*, 674 N.E.2d at 286.

markets, to use its authority under this chapter to facilitate the establishment of a national market system for securities.’⁵⁶ This ideal included Congress’s intent to promote economically efficient execution of securities transactions and facilitate greater competition in the industry for customer orders.⁵⁷

The SEC, an administrative agency, deriving its regulatory authority from Congress,⁵⁸ exercised its power to promulgate Rule 10b-10 pursuant to this grant of authority. Rule 10b-10 required a broker to disclose, in a confirmation, *inter alia*, whether any remuneration was received in connection with the customer’s transaction.⁵⁹ The Court of Appeals noted that, subsequent to the promulgation of Rule 10b-10, the SEC consistently applied the requirements of that rule to POF.⁶⁰ The court drew support for that proposition from a SEC release in 1993 in which the SEC proposed to amend Rule 10b-10 to require disclosure of POF upon opening a new account.⁶¹ The court appeared to interpret the

⁵⁶ *Id.* (emphasis added) (citation omitted).

⁵⁷ *See id.* at 289.

⁵⁸ *See, e.g.,* Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 699 (1984) (quoting Fidelity Fed. Sav. & Loan Ass’n v. De La Cuesta, 458 U.S. 141, 153 (1982) (“Federal regulations have no less pre-emptive effect than federal statutes.”); *Guice*, 674 N.E.2d at 285 (noting that administrative agency regulations, promulgated pursuant to congressionally delegated authority, may also preempt state law).

⁵⁹ *See Guice*, 674 N.E.2d at 286 (quoting Securities Confirmations, Proposed Rule, Securities Exchange Act Release No. 34-12806, 41 Fed. Reg. 41,432 (1976) (codified at 17 C.F.R. pt. 240.10b-10, 240.11Ac1-3) (proposed Sept. 16, 1976)) (emphasizing that the disclosure requirements of rule 10b-10 were proposed by the SEC as “a uniform rule applicable to all who wish to effect transactions for or with investors”); *see also* 17 C.F.R. § 240.10b-10 (1977).

⁶⁰ *See Guice*, 674 N.E.2d at 287. *But see* Dahl v. Charles Schwab & Co., 545 N.W.2d 918, 924 (Minn. 1996) (refuting Schwab’s argument that the SEC had acknowledged that rule 10b-10 applied to order flow payments, because the NASD, which is policed by the SEC, had notified its broker of that fact). The *Dahl* court stated:

If the SEC had issued this notice instead of the NASD, then the express preemption question would be a closer one. But Congress did not delegate supervision of the securities industry to the industry itself. SROs are not governmental agencies, they are private associations. . . . [W]hile SROs may regulate, only the SEC does so with the authority of and on behalf of the Congress. The fact that some in the securities industry may have considered Rule 10b-10 applicable to order flow payments has no effect on whether the SEC intended it to be such. Neither Rule 10b-10, nor the NASD Notice to Members, therefore, expressly preempted the application of state law.

Id.

⁶¹ *See Guice*, 674 N.E.2d at 287 (citing Payment for Order Flow, Securities and Exchange Commission Release No. 34-33026, 58 Fed. Reg. 52,934, 52,940 (1993))

SEC's 1993 proposal to amend Rule 10b-10, and its adoption of Rule 11Ac1-3, as acknowledgment that the SEC had exercised its jurisdiction over POF all along.⁶² It seemed that the court simply acquiesced to the SEC's jurisdiction and searched for ways to justify its ruling. The tone of the opinion was one of relief, as if the court was pleased to rid itself of a complex securities issue.⁶³

The Court of Appeals devoted two pages of its opinion to the 1994 amendments to Rule 10b-10 and promulgation of Rule 240.11Ac1-3.⁶⁴ The court noted that the SEC, after conducting a study of POF, and requesting comment regarding the effect of POF on the market, rejected a recommendation that the practice be prohibited.⁶⁵ Ultimately, the SEC found that "the securities industry gained economic advantages from the practice, which ultimately benefited the investor public."⁶⁶ The SEC's subsequent approval of POF, however, had no retroactive effect on the facts of the case and was irrelevant to the preemption issue.

After its discussion of the 1994 amendments, the court finally examined the real issue: Whether the 1975 amendments to the Exchange Act, and the SEC rules promulgated pursuant thereto, preempted state law claims challenging POF. The court conceded that under New York agency law⁶⁷ and the Restatement

(codified at 17 C.F.R. pt. 240.10b-10, 240.11Ac1-3) (proposed Oct. 13, 1993). In the same release, the SEC acknowledged that the practice of payment for order flow "may be a breach of the duty owed by a broker to its customer and is not permitted under general agency law." *Payment for Order Flow*, 58 Fed. Reg. at 52,938-39.

⁶² See *Guice*, 674 N.E.2d at 287.

⁶³ See generally *id.*

⁶⁴ See *id.* The court noted that the SEC had conducted extensive studies on the subject of POF and found that the practice lowered transaction costs, created competition in the market and thus, ultimately benefited the public. See *id.* at 287. Furthermore, the court noted that the SEC believed that requiring brokers to disclose the exact remuneration per transaction would be unworkable and unduly burdensome. See *id.* at 288 (footnote omitted).

⁶⁵ See *Payment for Order Flow*, Securities and Exchange Act Release No. 34-33026, 58 Fed. Reg. 52,934, 52,941 (codified at 17 C.F.R. pt. 240.10b-10, 240.11Ac1-3) (proposed Oct. 3, 1993) ("These alternatives include requiring that payment for order flow be passed through to customers; adopting a decimal-based system for the pricing and reporting of all securities for which transactions are reported on the consolidated tape; or, banning the practice outright as inconsistent with the Act.").

⁶⁶ *Guice*, 674 N.E.2d at 287 (citing *Payment for Order Flow*, Securities and Exchange Act Release No. 34-33026, 58 Fed. Reg. 52,934, 52,939-52,940) (to be codified at 17 C.F.R. pt. 240) (proposed Oct. 13, 1993).

⁶⁷ See *Guice*, 674 N.E.2d at 289. The court stated:

Disclosure . . . indefinite and equivocal does not set the agent free to bargain for his own account or for the account of a corporation which acts through him alone. If dual interests are to be served, *the disclosure to be ef-*

(Second) of Agency⁶⁸ the plaintiffs might very well have won the case because "no specific pretransaction disclosure of defendants' receipt of order flow payments was made . . . which disclosure might have affected the judgment of the customers."⁶⁹

Nevertheless, the court held for the defendant, reasoning that it would be unduly burdensome to require brokers to tailor their disclosures to the demands of each jurisdiction.⁷⁰ Moreover, allowing states to impose additional or more stringent requirements, would "inevitably defeat the congressional purpose of enabling the SEC to develop and police . . . a national market system."⁷¹ One may infer, therefore, that despite the savings clause in the Exchange Act,⁷² any state requirement more stringent than a federal law is implicitly preempted.

Plaintiffs' final claim in *Guice*, was that the savings clause preserved state law claims in the securities industry.⁷³ The court quickly dismissed this argument and concluded that the savings clause preserves state law claims unless state law conflicts with

fective must lay bare the truth, without ambiguity or reservation, in all its stark significance.

Id. (quoting *Wendt v. Fischer*, 154 N.E. 303, 304 (N.Y. 1926)).

⁶⁸ See RESTATEMENT (SECOND) OF AGENCY § 390 (1958). Section 390 states: An agent who, to the knowledge of the principal, acts on his own account in a transaction in which he is employed has a duty to deal fairly with the principal and to disclose to him all facts which the agent knows or should know would reasonably affect the principal's judgment

Id. The commentary to section 390 further states:

One employed as agent violates no duty to the principal by acting for his own benefit if he makes a full disclosure of the facts to an *acquiescent* principal and takes no unfair advantage of him. *Before* dealing with the principal on his own account, however, an agent has a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely. A fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent to the agent to enter into the particular transaction on the specified terms.

Id. § 390 commentary at 208 (emphasis added).

⁶⁹ See *Guice*, 674 N.E.2d at 289.

⁷⁰ See *id.* at 290 ("Securities broker-dealers, confronted with the risk of nationwide class action civil damage liability . . . would be impelled to tailor their disclosures to each State's common-law agency jurisprudence, and the carefully crafted SEC disclosure requirements would have little, if any, influence.").

⁷¹ *Id.*

⁷² See 15 U.S.C. § 78bb(a) (1994).

⁷³ See *Guice*, 674 N.E.2d at 291.

any other provisions of the Exchange Act or any rules promulgated thereunder.⁷⁴

III. APPLYING THE SUPREME COURT TEST TO *GUIDE*

It is uncontested that express preemption is inapplicable to plaintiffs' state law cause of action.⁷⁵ POF, until 1994,⁷⁶ was

⁷⁴ See *id.* (acknowledging that the purpose of the savings clause was to provide the states with as much leeway to regulate the securities industry as the Supremacy Clause would allow, and, in particular, to save state "blue sky" laws).

⁷⁵ See *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918, 923-24 (Minn. 1996). The court disagreed with Schwab's argument that there was explicit preemption stating:

It might be possible to read Rule 10b-10 as relating to situations involving paying for order flow, but the language of the rule does not rise to the level of a "clear and manifest purpose" mandated by the Supreme Court. Given that there is also no contemporaneous commentary by the SEC indicating that the rule applied to order flow payments, if there is any preemptive force in Rule 10b-10, it is implied, not express.

Id. (citation omitted). But see generally *Dumont v. Charles Schwab & Co.*, 717 So.2d 1182, 1182-85 (La. Ct. App. 1998). The court disagreed with other state court determinations reasoning that the 1995 amendments to rule 10b-10 and the promulgation of rule 11Ac1-3 proved the SEC's intent to preempt state law challenges to POF. The court acknowledged that POF was not mentioned in any of the legislative history to the 1975 congressional amendments nor in the background or purpose of rule 10b-10 promulgated by the SEC in 1977. See *id.* at 1185. Nevertheless, the court found that rule 10b-10 expressly preempted state law. See *id.* (demonstrating intention to abrogate state law effect).

⁷⁶ In 1994, the SEC adopted rule 11Ac1-3 and amended rule 10b-10 in order to preserve the practice of POF as well as provide the investor with greater protection through more complete and timely disclosure. See 17 C.F.R. § 240.10b-10 (1999). The regulation reads, in pertinent part:

Preliminary Note. This section requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction. The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision.

(a) *Disclosure requirement.* It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security . . . unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing: . . .

(C) For a transaction in any subject security . . . authorized for quotation on an automated interdealer quotation system . . . a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and the fact that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer

never mentioned in any SEC provision, nor was it discussed in nearly 200 pages of legislative history leading to the 1975 amendments.⁷⁷ A finding of implicit preemption is similarly unwarranted.

The court reasoned that the SEC, pursuant to the NMS and its delegated authority as the agency responsible for implementing the NMS,⁷⁸ created Rule 10b-10 and the rule applied to POF.⁷⁹ The court continued, "the SEC, acting reasonably within its rule-making authority, adopted a policy . . . of *permitting* the practice of order flow payments and not unduly inhibiting the practice by oppressive disclosure requirements."⁸⁰ The court ignored the important distinction between permitting POF and preempting a state from regulating that activity.

At least one scholar has noted that mere knowledge that the SEC's policy is to provide full disclosure is not as important as knowing *why* the policy is full disclosure.⁸¹ Similarly, in *Guice*, it

(d) *Definitions . . .*

(9) *Payment for order flow* shall mean any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution . . .

Id.; see also 17 C.F.R. 240.11Ac1-3 (1998), cited *infra* note 86.

⁷⁷ See S. REP. NO. 94-75, at 1 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 179; H.R. CONF. REP. NO. 94-229, at 87 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 321.

⁷⁸ See David A. Kessler, *Investor Casualties in the War for Market Efficiency*, 9 ADMIN. L.J. AM. U. 1307, 1309 (1996) ("Specifically, Congress granted the Securities and Exchange Commission (SEC) permission to preempt state investor protection statutes that the agency believes would impede a national system of securities settlement from operating safely and efficiently.") (footnote omitted).

⁷⁹ See *Guice*, 674 N.E.2d at 290.

⁸⁰ *Id.* (emphasis added).

⁸¹ See Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1500 (1986) (applying this theory to the issue of disclosure in tender offers). Professor Karjala expressed the importance of this notion suggesting that once Congress's purpose is determined, it is the job of the court to interpret the provisions and apply them to cases in accord with this purpose. See *id.* ("The crucial question is *why* Congress has required such detailed disclosure in the tender offer context. Once that purpose has been determined, courts should interpret the provisions, to the extent their language permits, to effect that purpose."). Thus, the *Guice* court, realizing that the predominant purpose of the Securities Act and the Exchange Act is to provide full disclosure to investors, should have found for plaintiffs as there was no preemption, nor was Schwab's material omissions regarding POF worthy of protection under Rule 10b-10.

is relevant that POF is not mentioned in the legislative history. The more important question, however, is why it is not mentioned. It is submitted that the legislative history was devoid of any mention of POF because in 1975 neither Congress nor the SEC was aware of the practice. Thus, preemption of an unknown practice such as POF could not have been within the contemplation of the 1975 amendments.⁸² What is unquestioned is that the securities industry was aware of this practice by the mid-1980s,⁸³ and by the end of that decade, this practice became the subject of extensive study.⁸⁴

The court's ruling has done an injustice to the investing public as a whole by following the irrational precedent set by the Minnesota Supreme Court in *Dahl*.

⁸² See, e.g., *Orman v. Schwab*, 676 N.E.2d 241, 248 (Ill. App. Ct. 1996) (Zwick, P.J., dissenting), *aff'd.*, 688 N.E.2d 620 (Ill. 1997).

[M]y research indicates that payment for order flow is a fairly recent practice which grew up after the SEC's promulgation of Rule 10b-10 in 1977. Order flow payments appear to have first come to the attention of the news media and the National Association of Securities Dealers only in 1985. . . . It follows that payment for order flow by brokers *could not* have been contemplated or specifically regulated in 1977 by Rule 10b-10 when the SEC promulgated the rule. It is not surprising, therefore, that the 1976 SEC release asking for public comment on then proposed Rule 10b-10 does not mention payment for order flow. Instead, the release explains that the proposed rule is designed to deal with a quite different problem, namely, "with agency crosses in the over-the-counter market where the broker acts as agent for both the buyer and the seller."

Id. (citations omitted); see also Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675, 1676 n.8 (1994) (noting that POF became recognized by scholars around 1985); cf. *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918, 921 (Minn. 1996) (theorizing that the practice of payment for order flow began in the 1960's and now is widespread in the securities industry); Richard L. Stone & Jay Facciolo, *Order Flow Cases: Jurisdiction, Preemption and Securities Laws*, N.Y.L.J., May 9, 1995, at 1, 4 (stating that the practice has a long standing history but has only spread to listed securities within the past seven years).

⁸³ See NASD Notices to Members, Number 85-32, 1985 NASD LEXIS 114, *1 (Apr. 30, 1985) (notifying members that the practice of payment for order flow had come to the attention of the NASD and that any members engaging in the practice should, at a minimum, comply with rule 10b-10. The notice advised the members that the NASD had begun an investigation into the effect of this practice and members would be advised further upon the results of the study).

⁸⁴ See generally *The Perils of Payment for Order Flow*, *supra* note 82 (summarizing the effects of POF and the studies of the practice leading up to the 1994 amendment to rule 10b-10 and the adoption of rule 11Ac1-3). This article analyzed the arguments proffered to the SEC against POF. Of particular concern to market analysts were "best execution" of a customer's orders and the structure of the equity market (specific concerns included liquidity, public confidence, price stability, pricing efficiency and competitiveness). See *id.* at 1678-83.

In analyzing the 1994 amendment to Rule 10b-10 and the SEC's reasoning behind the promulgation of Rule 11Ac1-3, the *Guice* court misdirected its attention, as these rules have no retroactive effect to the issues presented in the case. Since that Pandora's Box was opened, it makes sense to look inside.

The court relied on the SEC's promulgation of Rule 11Ac1-3 in 1994 as if it were a ringing endorsement by the SEC in favor of POF. The debates leading up to the 1994 amendments prove this assumption false. In fact, SEC Chairman, Arthur Levitt, criticized POF.⁸⁵ The SEC, after considering many options, including banning the practice, ordered a cost/benefit analysis of POF. After analyzing the results, the SEC approved the practice provided the customer is informed, at the time the account is *opened*, of the fact that the broker may receive remuneration in connection with the transaction.⁸⁶ This indicates that protecting the investor's right to make an informed decision remains a priority for the SEC.⁸⁷

The actions of the SEC in 1994 do not confirm the *Guice* court's theory that the SEC had preempted state law affecting POF since 1975. Quite the contrary, it is unlikely that the SEC, aware that brokers in the industry in which the SEC regulates,

⁸⁵ SEC Chairman Arthur Levitt stated that payment for order flow may adversely effect the market because the practice has the "potential to reduce competition based on published quotes." William Power, *Order Flow Fees Continue at Schwab*, WALL ST. J., Dec. 15, 1995, at C1 (internal quotation omitted).

⁸⁶ See 17 C.F.R. § 240.11Ac1-3 (1998). Section 240.11Ac1-3 provides, in pertinent part:

- (a) No broker or dealer acting as agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for purchase or sale of, any subject security . . . or a security authorized for quotation on an automated inter-dealer quotation system . . . unless such broker or dealer informs such customer, in writing, upon *opening* a new account and on an annual basis thereafter, of the following: (1) The broker's or dealer's policies regarding receipt of payment for order flow . . . including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and (2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow . . . absent specific instructions from customers, including a description of the extent to which orders can be executed [at] prices superior to the best bid or best offer . . .

Id. (emphasis added).

⁸⁷ See Karjala, *supra* note 80, at 1501-02 (noting that in the area of proxy solicitation, Congress believed that state law, when coupled with full disclosure, would protect shareholders from potentially injurious acts of management).

were practicing common law fraud, intended to preempt state law claims, and yet, neglected to explicitly do so. A more plausible inference is that the SEC became aware of POF and the controversy surrounding the practice and asserted itself on this issue in 1994. Cognizant of common law fiduciary duties and ignorant to the practice of POF, the SEC's likely purpose in 1977 was to supplement, rather than preempt, state law. This is so, particularly in light of the fact that subsequent disclosure is extremely ineffective as a method of investor protection.⁸⁸

The court failed to explain why it believed the SEC, a congressionally created regulatory agency whose predominant purpose is to protect investors by demanding "full and frank disclosure",⁸⁹ would suddenly ignore the savings clause and disallow

⁸⁸ See *The Perils of Payment for Order Flow*, *supra* note 82 at 1685.

[T]he vague, small-print disclosure required by Rule 10b-10 does not adequately alert customers to the presence of payments for order flow. . . . [E]x-post acquiescence is not the ex-ante agreement that agency law seems to mandate before the agent can keep profits derived from a transaction on behalf of his principal.

Id. (footnotes omitted). In addition, the article noted that the confirmation statement advises the customer that upon request, the broker will disclose more information about the remuneration received. The author stated, "[t]his boilerplate is unlikely to provide customers with the information necessary to enable them to make informed decisions." *Id.* at 1691; see also *Payment for Order Flow*, Securities and Exchange Act Release No. 34-33026, 58 Fed. Reg. 52,934, 52,937 (codified at 17 C.F.R. pt. 240.10b-10, 240.11Ac1-3) (proposed Oct. 6, 1993). This reads:

Allowing post-confirmation description of additional compensation eases the difficulty for broker-dealers of disclosing diverse additional compensation arrangements; however, this disclosure method may not effectively inform customers of factors influencing the broker-dealers' execution of their orders. Unless a confirmation clearly indicates that payment for order flow is received, the customer will not be aware that the arrangement exists, much less that there is more information about the arrangement available from the broker-dealer upon written request.

Id. The problem with confirmations is that they are received after the transaction has been executed. This is contradictory to the purpose of protecting the investors' right to make informed decisions. The NASD determined that its members' confirmations were not highlighting the fact that remuneration was being exchanged in conjunction with the customer's transactions and proposed changes to the confirmation to alert the customer. See NASD Notices to Members, Number 90-11, 1990 NASD LEXIS 425, *3 (Mar. 1990).

⁸⁹ Lynn Katzler, Comment, *Should Mandatory Written Opinions be Required in all Securities Arbitrations?: The Practical and Legal Implications to the Securities Industry*, 45 AM. U. L. REV. 151, 153 (1995). Katzler stated:

Congress enacted the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), in response to the rampant speculation, fraud, and deception in the securities industry that had culminated in the stock market crash of 1929. Although the Securities Act and

state law claims. Nor did it offer much explanation as to how allowing state law claims would frustrate the NMS. Certainly, it is not impossible for brokers to comply with both the state and federal requirements.⁹⁰

The fact that a state's disclosure requirements are more stringent than those of the federal government does not necessitate a conclusion that compliance with both is impossible.⁹¹ The *Guice* court rejected the plaintiffs' contention that compliance with both federal and state disclosure requirements was possible. It did not hold that compliance with state and federal law was impossible, rather, the court reasoned that the methods by which Congress looked to achieve its goals would be interfered with because brokers would not be able to avoid liability under state law merely by complying with federal regulations.⁹² The court stated that "[i]t would be extraordinary for Congress, after devising an elaborate [balanced regulatory] system that sets clear standards,

the Exchange Act differ, they share common goals. The federal securities laws were created with two main purposes: (1) to protect investors by elevating their level of sophistication through the requirement of full disclosure regarding investments; and (2) to restore investor confidence in the securities markets by instilling trust in their efficient and honest operation.

Id. (footnotes omitted); see also Jeffrey A. Brill, "Testing the Waters"—*The SEC's Feet Go from Wet to Cold*, 83 CORNELL L. REV. 464, 466 (1998).

⁹⁰ See *The Perils of Payment for Order Flow*, *supra* note 82 at 1692 (noting that "disclosure is a low-cost solution that would not require a drastic change in the market's operations"). The article referred to the solutions explored by the SEC prior to promulgating 11Ac1-3, but this statement exemplifies the point that plaintiffs only seek disclosure so as to make an informed decision. Many courts seemed to believe that plaintiffs were seeking an outright ban because they were suing under state law.

⁹¹ See generally *North Star Int'l v. Arizona Corp.* Comm'n, 720 F.2d 578 (9th Cir. 1983). The court noted that although state requirements were more stringent than federal laws, it was possible to comply with both; thus, there was no conflict. See *id.* at 583. The court further noted that the state statute at issue was directed at securities offerings, while the Exchange Act of 1934 was aimed at disclosure. See *id.* at 582. Facially then, there could be no conflict, especially when Congress, in the Securities Act of 1933, specifically recognized the concurrent jurisdiction between state and federal court. See *id.*

⁹² See *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 291 (N.Y. 1996). The court stated:

The stricter standards of order flow payment disclosure which may be required under State common-law agency principles inevitably will supplant the disclosure rules of the SEC on the same subject and come to dominate the relationship between broker and customer, since the broker would not be able to avoid civil liability for acceptance of order flow payments merely by complying with Federal regulations.

Id.

to tolerate common-law suits that have the potential to undermine this regulatory structure."⁹³ It is questionable whether the standards set by Congress are so clear. Admittedly, the defendant would be subject to different state law requirements. It does not necessarily follow, however, that Congress's plan is frustrated or unreasonably interfered with.⁹⁴

As the Supreme Court decided in *CTS Corp. v. Dynamics Corp. of America*,⁹⁵ state law and federal law can co-exist, and a finding of preemption is warranted only if state law frustrates or makes compliance with federal law impossible.⁹⁶ In *CTS*, the Supreme Court decided that the purposes of Congress were not unreasonably interfered with and that state law "further[ed] the federal policy of investor protection."⁹⁷ The New York Court of Appeals also ignored the teachings of *Medtronic Inc. v. Lohr*,⁹⁸ a recent Supreme Court decision, holding that state requirements more stringent than those of the federal government are not presumed to be implicitly preempted and, may indeed, co-exist with their federal counterparts.⁹⁹

After analyzing the plain language¹⁰⁰ and the purpose of Rule 10b-10,¹⁰¹ understanding the decision of the *Guice* court is a

⁹³ *Id.* at 291 (quoting *International Paper Co. v. Ouellette*, 479 U.S. 481, 497 (1987)) (alterations in original).

⁹⁴ See *Nader v. Allegheny Airlines, Inc.*, 426 U.S. 290, 298-300 (1976) (noting that even absent a savings clause, a state law remedy is not to be foreclosed unless the state law was "so repugnant to the statute that the survival of such right would in effect deprive the subsequent statute of its efficacy; in other words, render its provisions nugatory"). The court further suggested that if a state and federal law were not "absolutely inconsistent," then both may co-exist. *Id.*

⁹⁵ 481 U.S. 69 (1987).

⁹⁶ See *id.* at 79. ("Because it is entirely possible for entities to comply with both the Williams Act and the Indiana Act, the state statute can be pre-empted only if it frustrates the purposes of the federal law.")

⁹⁷ See *Facciolo & Stone*, *supra* note 35, at 582 (quoting *CTS*, 481 U.S. at 83).

⁹⁸ 518 U.S. 470 (1996).

⁹⁹ *Id.* at 495.

¹⁰⁰ See 17 C.F.R. § 240.10b-10 (1999). The regulation provides, in pertinent part:

(a) *Disclosure Requirement.* It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security . . . unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing: . . .

(7)(iv) The source and amount of any other remuneration . . . received by him in connection with the transaction: *Provided, however*, That if, in the case of a purchase, the broker was not participating in a distribution, or in the case of a sale, was not participating in a tender offer, the written notification may state whether any other remuneration has been or will be re-

perplexing task. To accept the court's rationale, it is necessary to presume that the SEC chose to preempt state law without clarifying that it was overturning historical and fundamental principles of state common law fiduciary duties. These duties encompass the obligation of an agent to turn over any commission made while acting on behalf of the principal and the duty to seek the principal's approval before retaining any remuneration.¹⁰² Surely, the SEC would have explicitly preempted state law¹⁰³ if it intended to destroy a cornerstone of the agency-principal relationship.

The *Dahl*¹⁰⁴ court, like the *Guice* court and all the other state superior courts addressing the issue of POF, held state law claims to be preempted, without clearly explaining how Congress's legislative intent behind the 1975 amendments would be frustrated.¹⁰⁵ The rationale of a few state appellate courts, con-

ceived and that the source and amount of such other remuneration will be furnished upon written request of such customer

Id. (emphasis added).

¹⁰¹ See generally Securities Confirmations, Securities and Exchange Commission Release No. 34-12806, 41 Fed. Reg. 41,432, 41,432-33 (1976) (codified at 17 C.F.R. pt. 240.10b-10, 240.11Ac1-3) (proposed Sept. 16, 1976). The purpose of rule 10b-10 was to facilitate the executions of transactions. Included in the proposed changes was a requirement that brokers send a disclosure statement every month rather than upon each transaction. Another main concern was for brokers to disclose to the customer whether the *dealer* were acting on his own behalf or for the customer. It is important to note that a dealer by definition is distinct from a broker in that a dealer is not an agent to the customer. Dealer transact for themselves and of their own volition.

¹⁰² See Karjala, *supra* note 81, at 1488 (commenting that Congress is aware when it is intruding on grounds traditionally left to the states and that absent an explicit preemption of the particular field, a careful investigation of the Congressional intent is required).

¹⁰³ In light of the 1994 amendment to rule 10b-10 and the adoption of rule 11Ac1-3, a much stronger argument can now be made for implicit, and even express, preemption. It is quite likely that a court would find there to be express preemption in the new rules as there is now direct language regarding order flow payments. Furthermore, there is ample evidence, from the SEC releases and studies the SEC conducted, to support a finding of preemption. Nevertheless, the SEC refrained from explicitly excluding state law causes of action to be invoked in the area of order flow payments.

¹⁰⁴ *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918 (Minn. 1996).

¹⁰⁵ See generally *id.* at 923-24. See, e.g., *Orman v. Charles Schwab & Co.*, 688 N.E.2d 620, 622-24 (Ill. 1997) (noting that payment for order flow "easily" comes under the term "remuneration" in rule 10b-10). The *Orman* court noted that the duty of the SEC was to facilitate efficient transactions and promote fair competition among brokers, and dealers, and exchange markets. Nowhere in the opinion was an explanation of how these goals would be frustrated. See *id.*

cluding that there was no preemption, is more persuasive. Generally, these courts concluded that far from frustrating the intent of Congress, the additional disclosure required by the states actually furthered the purpose of Congress and the SEC respectively.¹⁰⁶ Moreover, three federal courts¹⁰⁷ have considered the issue of preemption in POF cases, and all three courts have remanded the matter to state court, concluding that there is no federal jurisdiction.¹⁰⁸ This is significant because federal courts are more familiar with securities cases and thus, are more attuned to what Congress and the SEC envision as "their territory" regarding preemption of state laws.

The *Guice* court also underestimated the importance of the savings clause. Congress, by explicitly preserving state law remedies through the savings clause, contemplated that inevitably there would be dual litigation in federal and state court.¹⁰⁹ The Supreme Court has traditionally viewed the savings clause as "plainly intended to protect, rather than to limit, state

¹⁰⁶ See, e.g., *Dahl v. Charles Schwab & Co.*, 524 N.W.2d 742, 745-47 (Minn. 1994), *rev'd*, 545 N.W.2d at 918. The court concluded that state law was not preempted and that state law may indeed further the purpose of Congress and the SEC. The court ruled that the state law requirements would not "frustrate the ongoing regulatory activities of the SEC." *Id.* at 747. Furthermore, the court acknowledged that while the SEC imposed regulation of payment for order flow in 1994, the fact remained that there were no relevant, specific regulations at the time of this case. See *id.* at 745; see also *Guice v. Charles Schwab & Co.*, 630 N.Y.S.2d 317, 318-19 (N.Y. App. Div. 1995), *rev'd*, *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. Ct. App. 1996). The *Guice* court agreed with the appellate court in *Dahl* and ruled that there was no conflict between state and federal law. Furthermore, Congress had never dealt with the issue of POF and the SEC had not yet promulgated rule 11Ac1-3. Thus, state law was not preempted.

¹⁰⁷ See *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996), *cert. denied*, 520 U.S. 1118 (1997) (noting that two Louisiana Federal District Courts and another in Maryland ruled that there was no federal jurisdiction in POF cases).

¹⁰⁸ See, e.g., *Thomas v. Charles Schwab & Co.*, No. 95-0307-A, 1995 U.S. Dist. LEXIS 12007, at *1-*6 (W.D. La. 1995). The court decided that the federal district court did not have subject matter jurisdiction because complete federal law preemption did not exist, therefore, there was no federal question presented. Thus, the case was properly remanded to state court. See *id.* at *6. The court ruled that there was no explicit preemption and that congressional intent to preempt state law could not be inferred. See *id.* at *4-*5. Furthermore, the court ruled that the additional disclosure requirements of the state did not conflict with SEC regulations. See *id.* at *5.

¹⁰⁹ See *Matsushita Elec. Indus. Co., Ltd., v. Epstein*, 516 U.S. 367, 383 (1996) (noting that in enacting the savings clause, "Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions").

authority."¹¹⁰ Even Rule 10b-10, on which Schwab's claim of preemption is based, acknowledges that the disclosure requirements of 10b-10 are not exclusive.¹¹¹ After reading this provision, it is hard to imagine a clearer intent to preserve state regulation.¹¹² The Supreme Court has traditionally been reluctant to find implicit preemption of state law.¹¹³ For example, Justice Scalia, concurring in *CTS*, claimed that the savings clause should be interpreted to foreclose an analysis of preemption based on congressional purpose entirely, leaving the court to examine potential conflict between state and federal law.¹¹⁴ The savings clause has never been amended and in their appeal to the Supreme Court, plaintiffs' counsel noted that both the Securities Act of

¹¹⁰ *Leroy v. Great W. United Corp.*, 443 U.S. 173, 182 n.13 (1979) (noting that "Thomas Corcoran, a principal draftsman of the 1934 Act, indicated to Congress that the purpose of § 28(a) was to leave the States with as much leeway to regulate securities transactions as the Supremacy Clause would allow them in the absence of such a provision"); see also *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996) (pointing out that Congress never intended federal regulation of the securities industry to preempt the States unless stated specifically), *cert. denied*, 520 U.S. 1118 (1997).

¹¹¹ See 17 C.F.R. § 240.10b-10 (1999) ("The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision."); see also *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996), *cert. denied*, 520 U.S. 1118 (1997).

Footnote 28 of the 1977 SEC Exchange Act Release accompanying Rule 10b-10 states that "[t]he rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities." Exchange Act Release No. 13508, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143 at 87,930 n.28 (May 5, 1977).

¹¹² Indeed, the Supreme Court had the same observation. See, e.g., *Leroy*, 443 U.S. at 182 ("The section was plainly intended to protect, rather than to limit, state authority.").

¹¹³ See, e.g., *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963) (stating that preemption will not be found unless either "the nature of the regulated subject matter permits no other conclusion, or . . . Congress has unmistakably so ordained"); *Schwartz v. Texas*, 344 U.S. 199, 202-03 (1952). The *Schwartz* court noted that

[i]f Congress is authorized to act in a field, it should manifest its intention clearly. It will not be presumed that a federal statute was intended to supersede the exercise of the power of the state unless there is a clear manifestation of intention to do so. The exercise of federal supremacy is not lightly to be presumed.

Id.

¹¹⁴ See *Facciolo & Stone*, *supra* note 35, at 583 (citing *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 96 (1987)).

1933 and the Exchange Act of 1934 specifically preserved state law remedies in cases of fraud.¹¹⁵

IV. THE DIMINISHED PREEMPTION STANDARD, THE STATES' ROLE AND THE EFFECT ON SECURITIES LITIGATION

The idea that a phrase, such as National Market System, can be interpreted as preempting state law contradicts the Supreme Court's historically stringent preemption standard requiring Congress's clear manifestation of its intent to preempt. If preemption were the intent of Congress or the SEC regarding POF, it would have been simple enough to state as much.¹¹⁶

The reasoning of the *Guice* court implies that the SEC is the lone star in the securities field and state regulation is meaningless because any state law that differs from SEC rules or the rules of other states, by definition, defeats a NMS approach. Equally troubling is that both Congress and the SEC were silent on the issue of POF. Congress has not conveyed any desire for NMS to be interpreted as field preemption. Absent any clear intent, state laws may both co-exist with, and be more stringent than, SEC provisions and should not be preempted unless the Supreme Court standards are met. In *Guice*, the New York Court of Appeals lacked evidence of Congress's intent to preempt state law and is, therefore, erroneous.

It is clear that the Supreme Court standard for preemption was not met in *Guice*. The question remains, however, why the New York Court of Appeals, along with many other state supreme courts, refused plaintiffs the opportunity to bring a state law cause of action. One can only speculate, but it is this

¹¹⁵ See Petition for Writ of Cert., *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 1994 U.S. Briefs 5300, at 5-6 (Jan. 9, 1997) (No. 96-1105). The petition quoted language from a recent amendment of section 18 of the Securities Act of 1933:

(c) *Preservation of Authority.*—

(1) Fraud authority.—Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

Id. (quoting 15 U.S.C. § 77r (1996)).

¹¹⁶ See *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 487 (1996) (quoting *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984) ("It is, to say the least, 'difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct' and it would take language much plainer . . . to convince us that Congress intended that result.") (citation omitted)).

author's belief that state courts felt uncomfortable dealing with issues presenting federal ramifications. Perhaps, the courts were intimidated by the subject matter of the litigation and felt that the SEC was better equipped to handle this issue. Or maybe, because the financial stake per plaintiff was relatively small and the burden on defendants potentially large, interference with the authority of the SEC seemed unnecessary in light of the recent promulgation of Rule 11Ac1-3 which, of course, was irrelevant to the facts in *Guice*.

Whatever the reason may have been, there is no question that the *Guice* decision struck a devastating blow to state sovereignty. What does this decision reflect about the role of the state in regulating the securities industry? Eventually the state's role will need to be redefined, perhaps by the legislature in the form of field preemption or by the judiciary. After all, defendants nationwide, faced with allegations of violating state securities laws, will immediately argue that their clients' actions are regulated solely by the SEC under the guise of the National Market System and, thus, the claim is not actionable.¹¹⁷ Decisions such as *Guice* and *Dahl* perpetuate this defense and subsequently create a brand new preemption test not authorized by the Supreme Court.

Another case involving common law fiduciary duties which helps exemplify possible inequities that may occur when a court fails to administer an accurate preemption analysis is *In re Merrill Lynch*.¹¹⁸ This is a securities case involving an alleged violation of the duty of best execution. The plaintiffs alleged that the defendants were using a system referred to as the National Best Bid and Offer (NBBO)¹¹⁹ to execute plaintiffs' trades and

¹¹⁷ Indeed, *Guice* and its progeny are effecting the outcomes of breach of fiduciary duty cases and other securities related cases nationwide. See, e.g., *Gilman v. BHC Sec. Inc.*, 679 N.Y.S.2d 565, 565 (N.Y. App. Div. 1998) (holding plaintiffs' claims "identical in all pertinent respects" to those made in *Guice*); *Estate of Braunstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 657 N.Y.S.2d 12, 13 (N.Y. App. Div. 1997) (in finding that preemption existed, the court cited to *Guice* as authority for the proposition that when the SEC expressly regulates an area, that area is preempted); *Rosenfeld v. Bear Stearns & Co.*, 655 N.Y.S.2d 473, 473 (N.Y. App. Div. 1997) (affirming the trial court's approval of a negotiated settlement and noting that in light of *Guice*, the plaintiffs had very little chance of success). Where can these plaintiffs turn for relief? According to these cases, the SEC presents the only possible forum for plaintiffs as it controls all aspects of the securities industry.

¹¹⁸ 911 F.Supp. 754 (D.N.J. 1995), *rev'd sub nom.*, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir. 1998).

¹¹⁹ This system represents "the best bid and best offer of any OTC market maker in a particular security on the two-sided NASDAQ market." *Id.* at 756.

subsequently used alternative systems, such as Instinet and SelectNet, to execute trades on their own behalf, thereby turning a profit.¹²⁰

As in *Guice*, the plaintiffs here alleged that the defendants violated common law fiduciary duties.¹²¹ The district court granted a summary judgment motion in favor of the defendants.¹²² The court ruled in favor of the defendant despite the fact that there was no established industry standard and no express authorization by the SEC or the NASD allowing a broker to rely on any particular quotation system in fulfilling the duty of best execution.¹²³ The court also reasoned that since the SEC was *considering* the issue, the court should not interfere.¹²⁴ Furthermore, the court noted that requiring a broker to check each available quotation before executing a trade could be a burden to the efficient market.¹²⁵ Thus, the duty of best execution may have to take a back seat to market efficiency. Is this the result Congress envisioned when it uttered the phrase National Market System in 1975? Is this the correct standard to apply to determine whether a cause of action exists?

On appeal, the Third Circuit reversed the order for summary judgment, punctuating its disagreement with the district court's ruling, stating that, "[u]nder the district court's logic, [the] defendant[s] would be entitled to summary judgment even if it were her regular practice to knowingly violate the duty of best execution, so long as she could identify a sufficient number of other broker-dealers engaged in the same wrongful conduct"¹²⁶

¹²⁰ See *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d at 273. The practice that the plaintiffs alleged defendants engaged in was confirmed by an SEC study. *Id.*; see also Order Execution Obligations, Securities and Exchange Commission Release No. 34-37619A, 61 Fed. Reg. 48,290, 48,307-08 (codified at 17 C.F.R. 240.11Ac1-4) (proposed Sept. 12, 1996).

¹²¹ See *Newton*, 135 F.3d at 270. The court agreed that the duty of best execution has its roots in common law agency principles.

¹²² See *Merrill Lynch*, 911 F. Supp. at 756.

¹²³ See *id.* at 770.

¹²⁴ See *id.* at 773. The court's reasoning was similar to that of the *Guice* court. The court suggested that the rapid evolution of the market place required the expertise and attention of the SEC exclusively, and the SEC is the regulatory agency chosen by Congress as the sole watchdog of the securities market. In other words, where the SEC has spoken, a court has no business interfering with how the securities industry is regulated.

¹²⁵ See *id.* at 770.

¹²⁶ *Newton*, 135 F.3d at 274.

Admittedly, there are valid reasons to continue enhancement of the NMS. The court touched on one of them stating that technology in the market place is expanding at an exponential rate, thus globalizing the market.¹²⁷ This is precisely the reason that courts must narrowly interpret the provisions of the Exchange Act and the corresponding rules promulgated pursuant thereto by the SEC and subordinate self-regulatory organizations. It is impossible for the SEC to legislate for every creative brokerage scheme. The courts should play the role of gap filler by applying state law to areas in which the SEC has not yet asserted itself, or to those, which, although addressed, may be vague as to their coverage, such as POF. Additionally, the courts should interpret existing rules in a manner consistent with the legislative intent of the Exchange Act. This would allow Congress's plan for NMS to flourish while leaving the states' with some ability to protect their citizens. The public, as a whole, benefits when courts work in conjunction with the SEC rather than shirk their responsibility in the name of SEC expertise and autonomy.

CONCLUSION

Throughout the history of our country the judicial system has struggled to balance the goals of Congress with the sovereign powers of the states. The Supreme Court has formulated standards for preemption, and it is evident that absent a clear manifestation from Congress of its intent, the presumption is against preemption. If there is no explicit preemption, implicit preemption may exist if compliance with both federal and state law is impossible, or state law would frustrate the intent of Congress.

The *Guice* court did not adhere to the stringent standard set forth by the Supreme Court. The court showed no evidence that Congress's goal of a National Market System would be frustrated by state law. On the contrary, state law supplementation strengthens the purpose of protecting investors by requiring full disclosure of material information. The legislative history of the 1975 amendments of the Exchange Act does not mention POF, nor does it suggest that the National Market System was intended to preempt state law. Moreover, the SEC did not mention POF when it promulgated Rule 10b-10 pursuant to the 1975 amendments.

¹²⁷ See *id.* at 271.

By disregarding the plain meaning rule and substituting their own intent for that of the legislature in interpreting the 1975 amendments, courts across the nation threaten to create a new standard for preemption in the securities industry. The power to defend against a state law claim by invoking the phrase "National Market System," despite the fact that neither Congress nor the SEC has contemplated the issue at hand, sets a dangerous precedent and restricts the states' ability to protect their citizens by challenging dubious corporate activity.